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IN THE

Supreme Court of the United States.

Filed Dec. 4, 1899.

OCTOBER TERM, A. D. 1899.

UNITED STATES RUBBER CO., L. CANDEE & CO. and METROPOLITAN NATIONAL BANK OF CHICAGO,

Petitioners,

vs.

AMERICAN DAE LEATHER CO. et al.,

Respondents.

Petition for Writ of Certiorari.

436

BRIEF ON MOTION FOR CERTIORARI.

EDWARD S. ISHAM,
GEORGE A. FOULKROD,
HENRY S. ROBBINS,
Attorneys for Petitioners.

The Rumford Printing Company, 29 Jackson St., Chicago.

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Petition for Writ of Certiorari.

BRIEF IN SUPPORT OF PETITION.

There are two questions in this case, as follows:

1. Whether certain preferences given by an Illinois trading corporation while insolvent to the petitioners, three of its creditors, are fraudulent, and therefore invalid; and,

2. If so, whether the conduct of petitioners in taking and relying upon such preferences was such as to justify the court, when distributing the insolvent estate, in postponing their claims to those of the other creditors and (to adopt the apt the expression of Mr. Justice Brown) thereby "practically confiscate them."

Upon the first question Judge Grosscup, who tried the case in the Circuit Court, and Mr. Justice Brown and Judges Woods and Jenkins, who heard the case in the Circuit Court of Appeals, decided against the petitioners. The second question Judge Grosscup decided in favor of the petitioners, as did Mr. Justice Brown in a dissenting opinion in the Court of Appeals, while the other two judges of that court decided against the petitioners' right to pro rate with the other creditors, and in this particular reversed the decree of the Circuit Court.

A writ of *certiorari* is now sought upon the ground that these questions are of such importance as to justify the decision thereof by this court. The decision of the lower court upon the first question is thought to be in principle inconsistent with that of this court in *Sanford Tool Co.* v. *Howe*, 157 U. S., 312; while the second question is one of such frequent recurrence that its settlement by greater concord of judicial opinion than now exists in the Seventh Judicial Circuit seems desirable. As the matter now stands the views of two of the judges of the Court of Appeals has made that the law in the Seventh Circuit which two other judges of the same court declare should not be the law.

For a number of years prior to January 6, 1896, C. H. Fargo & Co., a corporation, had conducted a large business (from $1,250,000 to $1,400,000 per annum) as manufacturers and wholesale dealers in boots and shoes in Chicago, with a factory at Dixon, Ill., having, in 1892, succeeded a firm of that name. This corporation was essentially a family affair, all its stock being owned by three brothers, Charles, Frank and Edward Fargo. From 1892 until January 9, 1896, these brothers constituted all its officers, Charles being president, Frank

vice-president and treasurer, and Edward secretary. They, together with four employes of the company who owned no stock and took no part in the management of its business (Rec., p. 159), constituted its board of directors.

On the 6th day of August, 1896, Fargo & Co. failed, and this resulted in the following preferences:

Two judgments by confession, August 6, 1896, in the Federal Court in Chicago, against Fargo & Co., one in favor of the United States Rubber Company for $145,400 upon a judgment note payable on demand for $140,000, and dated January 6, 1896, and one in favor of L. Candee & Co. for $38,300, upon a judgment note of the same date, due on demand, for $51,500.

An assignment, August 6, 1896, by Fargo & Co. to the United States Rubber Company of all its book accounts, etc., as collateral security to its indebtedness to said two rubber companies, pursuant to an agreement to so assign made January 6, 1896.

A judgment by confession in the State Circuit Court at Chicago, August 6, 1896, against Fargo & Co. in favor of the Metropolitan National Bank for $25,250, upon a judgment note dated August 5, 1896, and made by Fargo & Co., payable to said bank, for $25,000.

Two warranty deeds from Fargo & Co. to said bank, dated August 6, 1896, conveying its factory at Dixon, Illinois.

Upon the judgments in favor of the United States Rubber Company and L. Candee & Co. (hereafter called the rubber companies), executions were immediately issued and levied upon all the stock in trade and other tangible assets of Fargo & Co.: whereupon on the 11th

day of September, 1896, the American Oak Leather Company, after having obtained a judgment against Fargo & Co., and the return of an execution thereon *nulla bona*, filed the present bill against Fargo &Co., these petitioners and the marshal, averring a diversity of citizenship of complainant and defendants, attacking the foregoing preferences as illegal, because made with intent to defraud, hinder and delay the other creditors of Fargo & Co., and praying that the same might be set aside and its assets applied to the payment of its *bona fide* creditors.

Subsequently other creditors, whose claims aggregated about $150,000, joined complainant in the suit.

After the case was at issue the Circuit Court, on motion of complainant, referred it to Henry W. Bishop, Esq., master in chancery, "to take proofs herein and report the same, together with his conclusions thereon, as to the facts only" (Rec., p. 156), and after a protracted hearing the master made his report, finding the facts to be substantially as set forth in the answers of these petitioners. That report, so far as relevant to this application, is as follows (Rec.,pp. 160–171):

"There was due January 6, 1896, to Candee & Company upon the notes of C. H. Fargo & Co. (given in settlement in November, 1895), the sum of $44,900, and on the same date there was due from the Fargo Company to the United States Rubber Company an open account for proceeds of sale of consigned goods the sum of $141,537.13.

It is shown by the testimony, and I so find, that about January 2, 1896, the C. H. Fargo Co., anticipating difficulty in meeting its regular obligations maturing during that month, applied to one Charles L. Johnson, who represented both the Candee Company and the United States Rubber Company, for a loan of $50,000, representing that the Fargo Company was perfectly solvent and that this accommodation would relieve it from its

temporary embarrassments, and enable it to go on with its business.

This application was granted, and on January 6, 1896, Johnson agreed, acting for L. Candee Company, to lend the Fargo Company the sum of $50,000 for six months upon the understanding that this loan and the indebtedness of $44,900 upon the notes previously given as aforesaid and the balance due the United States Rubber Company, and which might become due it, should be secured in such a way as might be satisfactory to their counsel, Mr. Beale, of the law firm of Isham, Lincoln & Beale.

The proposition was accepted on the 6th day of January, 1896, and it was agreed and arranged between the parties as follows:

First. That the $50,000 should be advanced to the Fargo Company by L. Candee & Co., partly on that date and during the succeeding two weeks.

Second. That the Fargo Company should that day execute and deliver its three judgment notes, one for $45,000 payable on demand to the order of L. Candee & Company to secure that company with respect to its liability as endorser or guarantor upon the notes for $44,900 given previous to January, 1896, one for $51,500 payable on demand to L. Candee & Company, as collateral security to plain notes of the Fargo Company which were given as evidence of the advance of $50,000 then to be made, and one for $140,000 payable on demand to the order of the United States Rubber Company, as collateral security to the then existing and to any future indebtedness of the Fargo Company to the United States Rubber Company as aforesaid.

Third. That in case the Fargo Company should at any time find it necessary to suspend business, it would assign as additional security all its accounts and bills receivable; that it should not give any judgment notes to other creditors which would impair the security to the Rubber Companies, *and that the $50,000 advance should be used by the Fargo Company in reduction of its general indebtedness as it matured;* and

Fourth. That the four employes of the Fargo Company who were on the board of directors, and also E. A. Fargo, should retire from the board and there should be

elected in their places by the stockholders of the company five persons, to be nominated by said Beale, in whom he had confidence, one of whom should become secretary and treasurer, *and that the directors so to be elected at Beale's nomination should not hamper or interfere with the proper carrying on of the ordinary business of the company*

* * * * *

I find that the attention of the general creditors was never called to this arrangement and they had no knowledge of it. The Metropolitan National Bank first learned of it at or about the time a judgment note was given it to secure the payment of its claim of $50,000 as hereinafter stated.

I find that in pursuance of this arrangement, and on January 6, 1896, a meeting of the board of directors of the C. H. Fargo & Co. was had before any change in said board, when a resolution was passed authorizing the borrowing of the $50,000, the giving of judgment notes, as in said agreement provided for, and assignment of the accounts, bills and choses in action upon the contingencies agreed upon; and upon the same day the three judgment notes referred to were executed and delivered by Charles E. Fargo, president of the company; Frank M. Fargo, vice-president and treasurer, and E. A. Fargo, secretary, and the loan of $50,000 was perfected, $10,000 being advanced at the time and the balance of $50,000 during the succeeding two weeks.

This action was ratified on the 8th day of January, 1896, by the unanimous vote of the stockholders of C. H. Fargo & Co., all the shares being represented.

I find that in pursuance also of said arrangement, and as a part of it, at a meeting of the stockholders of C. H. Fargo & Co., held January 9, 1896, George C. Madison, Tiffany Blake, Buell McKeever, Frederick B. Fuller, Gilbert E. Porter, Charles E. Fargo and F. M. Fargo were duly elected directors for the ensuing year.

The first five, except Blake, were employes in the office of William G. Beale, and said Blake was assistant corporation counsel of the City of Chicago, of which William G. Beale was then corporation counsel, and all five were elected by the stockholders at the suggestion of said

Beale. Subsequently, at a meeting of the newly constituted board, at which Charles E. Fargo was re-elected president of the company, Frank M. Fargo was re-elected vice-president of the company and Buell McKeever was elected secretary and treasurer of the company, the by-laws of the company were amended providing against the giving of judgment notes or preferential security without special authorization of the board of directors.

I also find that the change of the board of directors and officers, and the changes of the by-laws of said company and the resolution thereof authorizing judgment notes and assignments of accounts if necessary, were all for the purpose of giving preferential security to the Rubber Companies, and the matter was kept secret in order to allow the Fargo Company an opportunity of getting through embarrassments apparently temporary but not with a fraudulent intent as to the other creditors of the company. The only purpose and object of changing the board of directors as aforesaid and of amending the by-laws was to protect the Rubber Companies against the giving by the Fargo Company of preferential security or judgment notes to other of its creditors which should be superior to the security of the Rubber Companies.

I further find that the arrangement as made was carried out in good faith by the parties and that the directors elected at the suggestion of said Beale took no part in the active management of the Fargo Company after their election, and that no stockholders' or directors' meetings of the Fargo Company were held after January 9, 1896, until August 5, 1896.

I find that on January 9, 1896, which was the date of the meeting of the new directors, the authorized capital stock of the said corporation of C. H. Fargo & Co. was $400,000 and the debts of the corporation on January 6, 1896, as follows:

Amount owing United States Rubber Company	$141,537 13
Amount owing Candee & Company	44,900 00
Amount owing Metropolitan National Bank.	50,000 00
Amount owing other creditors	210,216 20
Total	$446,653 33

I find that the value of the assets of C. H. Fargo & Co. at that time had not been definitely ascertained, but I find, as a matter of fact, as the results of efforts since made in collecting the same in liquidation and from other sources of information disclosed by the testimony, that on the 6th day of January, 1896, the assets of said company were not sufficient to discharge its indebtedness, *of which fact the defendants, the Rubber Companies, are shown to have been ignorant, relying upon the representation of the Fargos that there was a large excess of assets over liabilities.* The fact that Johnson, representing the Rubber Companies, made no detailed examination of the assets of the company, but consented to advance the money which was applied for, is evidence to my mind that he believed in the assurances which were given him by the Fargos of the condition of their company.

I further find that between Janaary 6, 1896, and August 6, 1896, the new liabilities incerred by said corporation to creditors other than the Rubber Companies and the bank were $246,660.54 (of which there was due and unpaid on August 6, 1896, $142,690.95), and that during the same period the Fargo Company paid out more than $300,000 to its general creditors in the regular course of business, paying substantially all of the indebtedness of January 6, 1896, which was largely to the same persons who are now creditors.

I further find that between January 6 and August 6, 1896, the Fargo Company continued its business as before, *reducing its general indebtedness to a considerable extent with its general creditors;* that during said time it paid Candee & Co. $44,900, the amount of its indebtedness prior to January 6, 1896, and $13,470 on account of the advance of $50,000 as aforesaid; that during said time it paid to the United States Rubber Company $15,000 on account of the indebtedness to that company existing January 6, but it also sold consigned goods of that company to the amount of $24,534.04, of which it remitted only $5,495.40; and that on August 6, 1896, there was due to the United States Rubber Company the sum of $142,424.81, and to L. Candee & Company the sum of $36,530.

I further find from the testimony that the indebtedness

of the Fargo Company which was incurred after January 9, 1896, up to the time of the entry of judgment upon the judgment notes referred to was incurred in ignorance of the giving of the judgment notes and the change of directors and of the change of officers and of the arrangement existing between the Rubber Companies and the Fargo Company, and that the amount of the claims that were thus contracted and is still unpaid exceeded $110,000.

I find that while Johnson and Sadler, representing the Rubber Companies, were here from January 2 to January 6, 1896, that it was then agreed that separate books showing sales of consigned goods should be kept and the proceeds of the sales thereof should be kept in a separate bank account, which was done.

I find that the advance of $50,000 on January 6, 1896, and the giving of the judgment notes and security referred to, was the result of an evident feeling upon the part of all the parties to the transaction, and was in the belief and expectation on their part, that through the assistance which was in this way afforded the Fargo Company it would be enabled to continue its business successfully and become ultimately relieved of its financial embarrassment, and that said arrangement was entered into in good faith and without any fraudulent intent.

I find that the testimony does not show that the parties were influenced in making the arrangement aforesaid upon a belief of the insolvency of the Fargo Company at that time, and the conduct of the corporation afterwards and until about the time of the entering up of the judgment notes, in my judgment, clearly indicated the hope and expectation that the Fargo Company would be finally relieved of its troubles.

In support of this conclusion I find that in the meantime, and between January 6, 1896, and August, 1896, in the regular course of its business the Fargo Company reduced to a large extent the indebtedness which existed on January 1, 1896, increasing the capacity of their manufacturing business, reducing its stock and discharging to a large extent its general liabilities, except with the United States Rubber Companies and the Metropolitan Bank, with an evident purpose and expectation of

continuing its business; during which time nothing is shown to have occurred with these parties inconsistent with this theory.

I find that during this period the general creditors were substantially the same as before, with the exception of the Eagle Tanning Works of Chicago, whose claim of $2,500.24 has been established, for the goods purchased on credit between April 1, 1896, and July 15, 1896, and Wilder & Company, and the Pfister & Vogel Leather Company, hereinafter mentioned.

* * * * *

And I also find that during this time upon the letter-heads of the C. H. Fargo Company the printed names of the Fargos, treasurer and secretary, appeared as before, without anything to show any change in the construction or management of said corporation, nor were such changes in any way mentioned, or their real condition disclosed.

* * * * *

I further find that during many years prior to January 6, 1896, the C. H. Fargo Company had been doing business with the Metropolitan National Bank of this city, its banker, resulting in the creation from time to time of a large indebtedness to said bank, which was finally reduced, in the usual course of business, so that on the 5th day of August, 1896, said indebtedness amounted to the sum of $40,000.

That the Metropolitan National Bank, during the summer of 1896, applied to C. H. Fargo & Co. to reduce its indebtedness to it and to finally discharge it by the month of November following.

I further find that at the same time said bank gave the C. H. Fargo Company said notice, and down to about the 3d or 4th day of August, A. D. 1896, it had no knowledge of any transactions which occurred between it and the Rubber Companies in the previous month of January; and that it did not know of the change in the board of directors of said C. H. Fargo & Co., or that it had given the Rubber Companies judgment notes for an indebtedness owing by it to said Rubber Companies, or of the agreement which had been entered into in respect to the same between it and the Rubber Companies, or of the action which had been taken by the newly constituted board in pursuance of this agreement.

I further find that on or about Monday, the 3d day of August, A. D. 1896, Charles E. Fargo, president of the said C. H. Fargo & Co., called at the Metropolitan National Bank, and while there applied to the bank for an additional loan of $10,000.

I find that during this interview, or shortly thereafter, the said Charles E. Fargo informed the president of said bank that the said C. H. Fargo & Co. had given the Rubber Companies judgment notes for the amount of its indebtedness to them, and that while said C. E. Fargo insisted that the assets of his company were at that time largely in excess of its indebtedness and ample to meet the entire amount thereof, that, owing to the difficulty in making its collections as rapidly as its outstanding paper matured, his company would be obliged to fail unless it received some assistance.

I find that at the time of said interviews the said C. H. Fargo represented to the president of said bank that the said C. H. Fargo & Co. was indebted to him and his brothers for money exceeding $10,000 which they had borrowed upon their notes for the benefit of the company, and which they had paid over to the company for use in its business, and that said Fargo brothers had put up some bank stock that they owned as collateral to said notes, and C. E. Fargo thereupon proposed to said bank that if it would loan said C. H. Fargo & Co. $10,000 in addition to its then existing loan, so that said company could reimburse him and his brothers and enable them to take up said notes, he would procure from the said C. H. Fargo & Co. judgment notes for said bank, both for said sum so advanced as aforesaid, and also for notes then remaining due said bank to the amount of $40,000.

I further find that said bank acceded to said proposition, and loaned said C. H. Fargo & Co. said additional sum of $10,000, receiving two judgment notes of the Fargo Company for the sum of $25,000 each, crediting to the amount of said C. H. Fargo & Co. in said bank said sum of $10,000.

I further find that at the time of the completion of this arrangement with said bank, neither the bank nor its officers nor attorneys had any knowledge of the change

of the board of directors of the said C. H. Fargo & Co., or of its by-laws, but the bank did know that the Rubber Companies, as a part of the final arrangements made, were entitled equally with themselves to enter judgment upon the judgment notes which had been given.

I further find that neither the complainants herein nor any of the other creditors of the said C. H. Fargo & Co. were led to give credit to said company by reason of the transactions had between it and the bank, nor did any of said parties sell any goods to said C. H. Fargo & Co. subsequent to the time when said bank made said $10,000 loan aforesaid to C. H. Fargo & Co., nor did the said bank in any way participate in or have any knowledge of the change in the by-laws of said C. H. Fargo & Co. as aforesaid.

I further find that from about the time when the said judgment notes were given to said bank, as aforesaid, the said bank entered into a stipulation with the Rubber Companies by which it was agreed that they should unite their efforts to collect their respective claims against the said C. H. Fargo & Co. and should share *pro rata* in whatever proceeds should be derived therefrom.

* * * * *

I further find upon the testimony submitted to and taken before me in connection with this branch of the case, that the defendant, the Metropolitan National Bank, is not shown to have been guilty of any actual fraud as against the complainants or the other creditors of C. H. Fargo & Co. by reason of any of its transactions with the said defendants, C. H. Fargo & Co. or the said Rubber Companies.

I further find that August 6, 1896, before entry of the judgments in favor of the Rubber Companies as set forth in the pleadings, C. H. Fargo & Co., by its president, C. E. Fargo, duly assigned to the United States Rubber Company all the accounts and bills receivable of the Fargo Company as further security for the indebtedness to the Rubber Companies, pursuant to and in accordance with the agreement made in January, 1896.

I find nothing in the testimony which has been taken before me upon this reference which so changes the record which was before the court upon the hearing of the ap-

plication for the appointment of a receiver as to lead me to a conclusion different from that announced by the court at that time; *indeed, the effect of the testimony, in my judgment, is to explain and strengthen the conclusion then expressed by the court, that there was no fraud in fact or want of good faith shown in the conduct of any of the defendants in respect to the transactions complained of; and upon a careful examination of the whole record and testimony I so find and report.*"

Sundry exceptions filed by complainant and the other creditors who had come into the suit were overruled by the Circuit Court and the report confirmed, the learned Circuit judge, after a careful examination of the evidence, saying: "I think the weight of proof shows that both these [rubber] companies believed that with the help they were about to give Fargo & Co., that company would be able to weather the storm. I am therefore of the conclusion that there was no intentional fraud committed." And the court, holding the preferences constructively fraudulent, proceeded:

"What punishment should the court, in view of the character of fraud found against the Rubber Company, and the Candee Company and the Metropolitan National Bank, inflict upon them? * * * Candee & Company, the Rubber Company, and the Bank, would undoubtedly, in January or in August, have had the rightful power to have obtained the judgment notes actually taken. Had they taken judgment thereon, there can be no doubt but that their preference would have been sustained. The vice in the conduct of the Rubber Company and the Candee Company consisted in their attempting to tie up the corporation against the power to give like preferences in favor of others. It was, in a certain sense, a new attempt; it was in the line of efforts of creditors to secure themselves; it was, on the whole, not ungenerous to Fargo & Co.; and did not, considering their rights to have taken judgment notes, and the fact that none of the other creditors attempted to obtain such notes, or any other preference before the general crash, do any

actual injury to the other creditors. On the whole I think the interests of justice will be best subserved by placing them in a class with the other creditors and compelling them to pay the general costs of this litigation." (Opinion, Record, p. 636–A.)

Thereupon, the decree appealed from was entered, setting aside the above preferences as "fraudulent in law (though not at the time believed by the parties to be such, but, on the contrary, believed to have been within their rights) as against the other creditors of C. H. Fargo & Co." and directing the assets of Fargo & Co. (about $111,000) in the hands of the receiver to be distributed *pro rata* among said creditors of Fargo & Co., including petitioners. (Record, p. 639.)

The case being taken by appeal and cross-appeal to the Court of Appeals, Mr. Justice Brown, in a dissenting opinion, concurred with Judge Grosscup in holding that while the preferences were constructively fraudulent, the petitioners were entitled to share *pari passu* with the other creditors, saying:

"To make it actually fraudulent, such as to require the claims of those preferred creditors to be postponed to the claims of the general creditors, I think it should clearly appear either that the preferred claims were not *bona fide*, of which there is no pretense, or that the arrangement was entered into, not for the purpose of tiding the company over its immediate crisis, enabling it to continue business, and at the same time to secure the preferred creditors, but for the purpose of ultimately winding it up, and in the meantime of giving it credit and enabling it to purchase additional goods, which the preferred creditors would thereby be able to seize and subject to their own debts.

"I find no testimony to satisfy me that an actual fraud upon the general creditors was intended. The device of changing the directors was evidently not for the purpose of giving up control of the business, but only to

secure the arrangement that no other judgment notes should be given, and as a matter of fact the new directors did not interfere with the business of the company as conducted by the Fargos. Indeed, no meeting of directors was held after the change was made. No new creditors were induced to give credit to the company upon the faith of their continuing the business, as the evidence shows that with few exceptions the same persons were creditors in January and August. * * *

"Upon the whole, it does not seem to me that such a case of fraud is made out as authorizes the court to postpone the claims of the preferred creditors to those of the general creditors, and thereby practically to confiscate them; and that there is no sound reason for departing from the general rule laid down by the Supreme Court in *White* v. *Cotzhausen* (129 U. S., 329), and *Streeter* v. *Jefferson County Bank* (147 U. S., 36), wherein the preferred creditors were permitted, after their security had been set aside, to stand upon an equality with the general creditors. * * *

"The evidence satisfies me that there was a *bona fide* attempt to assist the Fargo Company in continuing its business, with the hope of ultimately pulling it through, and that if this attempt had been successful, it would have redounded greatly to the interest of the general creditors. It was natural, at least, that in making this attempt the rubber companies should have endeavored to secure themselves, not only for their immediate outlay of $50,000, but for their prior debts. In palliation of the secrecy, which was held to make this constructively fraudulent, it may be said that publicity doubtless would have destroyed the entire scheme of raising money to carry on the business."

The majority opinion of the Circuit Court of Appeals (Rec., pp. 717-734) certainly does not in terms—and we think does not intend to—overrule the master's findings of facts. True, that opinion does in one place say that "the rubber companies were guilty of fraud in fact," whereas the master's report finds "there was no fraud in fact or want of good faith," but that opinion also says:

"Questions of fraud in law and fraud in fact are in their natures separate, though not always distinguishable by clearly defined lines. In this case * * * no attempt will be made as we proceed to keep the distinction all the while in view."

And again, in commenting on the language of the master's report, "but not with a fraudulent intent as to the other creditors of the company," the opinion says:

"If, however, the master intended, as it seems probable he did intend, to find that the parties to the scheme had no conscious purpose to harm either present or future creditors, the finding cannot abrogate or restrict the application of that familiar rule, without which a coherent code of law or morals would be impossible, that men shall be deemed to intend the natural or probable consequences of their acts or conduct. * * * The inventors of the scheme were bound to apprehend its probable consequences."

And again:

"It was hoped—let us say it was believed—by all concerned that with that sum [$50,000], under the plan agreed upon, the company would be able to weather the storm."

And again:

"It was not, as alleged in the bill, a part of the plan that increased purchases should be made for the purpose of improving the security of the rubber companies."

I.

The Right to Pro-Rate.

From the foregoing and other expressions of the majority opinion of the Court of Appeals, it is clear that petitioners' preferences were set aside and their claims practically confiscated by the Court of Appeals, not because of the motives and purposes of the parties to

the preferential transactions, not because of any design or intent on their part to commit a wrong upon the other creditors of the Fargo Company, but because of the supposed injurious *effect* of the transaction as to other creditors—an effect which rendered it illegal *independent of the actual intentions of the parties.* The intention here made the basis of the court's decision against petitioners is an intention imputed to them *as a matter of law.* Such imputed intention would warrant a court in setting aside a peference, but would not justify it in inflicting punishment.

The court here disregards the distinction between actual and constructive fraud, which is recognized and defined by this court in

Neal v. *Clark*, 95 U. S., 704-9,

where, in construing the use of the word "fraud" in the bankrupt act Mr. Justice Harlan said:

"It means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong * * * and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality."

It therefore seems apparent that the learned judge in saying petitioners were guilty of fraud in fact did not—as indeed he disclaims intention to—keep in view the distinction between fraud in fact and fraud in law, and that he did not in so characterizing the conduct of petitioners intend to overrule the master's finding that they were guilty of no *intentional* wrong to the other creditors. Had he intended to overrule the master the learned judge would doubtless have left no ambiguity in the opinion upon this point, especially in view of the rule frequently laid down by this court that the master's

findings shall, on appeal, be accepted as presumptively correct unless shown to be clearly wrong.

Tilghman v. *Proctor*, 125 U. S., 136–149.
Callaghan v. *Myers*, 128 U. S., 617-666.
Crawford v. *Neal*, 144 U. S., 585–596.
Furber v. *Ferris*, 145 U. S., 132.
Warren v. *Keep*, 155 U. S., 265.
Davis v. *Schwartz*, 155 U. S., 631-636.

Without in this application entering upon an argument in support of the master's report, it is safe to assume that did that report contain "any serious or important mistake" upon the evidence, it would not have been approved by Judge Grosscup or accepted by Mr. Justice Brown.

But, in truth—except as to certain subsequent representations claimed to have been made to two creditors by the Fargos, which cannot be proof of intentional wrong by petitioners, because they neither participated in nor knew of them—*there is no conflict of evidence in this case.* True, the inference of motives to be drawn from the uncontradicted evidence are a matter of controversy between counsel, but this is not very material, as none of the judges of the lower courts deduced from the evidence an *intention* or "conscious purpose" of petitioners to commit a wrong against the other creditors. Hence the second question above stated is in effect whether this undisputed evidence shows such conduct—concededly wanting in "conscious purpose" to wrong the other creditors—as should preclude the petitioners from participation in the *pro rata* distribution of the Fargo & Co. estate. This would seem to be a question of law.

It is submitted, in support of the application for the writ of *certiorari*, that not only is this question one which, in view of the diversity of views of the judges below, ought to be finally decided by this court, but that upon reason and authority under the decisions of this court the action of the Circuit Court of Appeals was wrong in denying, and Mr. Justice Brown and Judge Grosscup were right in upholding, the petitioners' right to pro rate with the other creditors.

In *Streeter* v. *Jefferson Bank*, 147 U. S., 36, a creditor of a bankrupt who had obtained a preference which this court adjudged illegal within the purview of the bankrupt act, was held not precluded thereby from proving his debt and sharing in the distribution of the bankrupt's estate.

In *White* v. *Cotzhausen*, 129 U. S., 329, this court, in setting aside, as contrary to the Illinois Voluntary Assignment Act, a conveyance by way of preference, held such transferees not debarred from participation in distribution, saying that:

"So far as the record discloses, they only sought to obtain a preference over the other creditors. But their attempt to gain such illegal preference ought not to have the effect of depriving them of their interest, under the statute, in the proceeds of the property in question."

In *Brown* v. *Morristown Store Company*, 42 S. W., 161 (Tenn., 1897), where the court set aside as an illegal preference a sale by a corporation to its treasurer of its assets in payment of its debt to him, the court said:

"We do not think the position taken by the general creditors under this writ of error, that Holston (the preferred creditor) is not entitled to participate as a creditor in the distribution of the assets of the corporation, is well taken. Resistance to the evidence of the sale to

him on the ground of its illegality does not debar him as a creditor or destroy his debt. * * * The effect of avoiding a sale in a case of this kind is, as we understand the law, to place the property of the corporation, as a trust fund, under the control of the court for equal distribution among all its creditors."

See, also, to like effect,

Comer v. *Tabler*, 44 Fed., 467.
In re Reed, 3 Fed. Rep., 798.
In re Cadwell, 17 Fed. Rep., 693.
Phelps v. *Curts*, 80 Ill., 109.
Lobstein v. *Lehn*, 120 Ill., 549.
Riggs v. *Murray*, 2 John. Ch., 565.

Why does not the principle of these cases apply to these petitioners? They have only made an unsuccessful attempt to secure perferences. Their *motive* in seeking a preference is, in Illinois, recognized as legitimate. If unsuccessful, it is not because they have sought what the law inhibits, but because, under legal advice, without intention to wrong the other creditors, they have adopted a *method* which the law will not sanction.

If, as intimated in *Clements* v. *Moore*, 6 Wall., 312, each case is to be decided—not by an inflexible rule—but according to its own circumstances, upon what ground can the rubber companies be fairly denied the right to pro rate? A corporation, of which they were the largest creditors became embarrassed and its officers desired to overcome—as they had a right to attempt to do (*Sanford Tool Company* v. *Howe*, 157 U. S., 312)—the difficulties which they regarded as but temporary. The rubber companies were willing to aid by advancing $50,000, if the Fargo Company would—as it lawfully might—(*Sanford Tool Co.* case, *supra*)—secure their existing

debts, and an arrangement was concluded under which the Fargo Company procured $50,000 of new money to be "used in reduction of its general indebtedness as it matured" (Master's report, p. 161), and was thus enabled for seven months to continue its struggle for business life. During this time its business was carried on as before and it "paid to general creditors in the regular course of business more than $300,000, paying all of the indebtedness of January 6, 1896, which was largely to the persons who are now creditors." During this time its indebtedness to its general creditors was materially reduced, while its debts to the rubber companies were reduced but a few thousand dollars.

It is not denied that in January, Fargo & Co. could lawfully have given, and the Rubber Companies could lawfully have taken, by way of preference, judgment notes to be immediately entered. Thus these general creditors considered collectively, as they should be, were better off under the arrangement than they would have been had it not been made, but in lieu thereof an arrangement for immediate cessation of business and preference had been entered into. For had the January arrangement fulfilled the expectations which the master finds were entertained by the parties to it (Rec., 164), and the Company had tided over its difficulties, all creditors would have been paid in full and these respondents would have profited by it as much as the petitioners. Is there in all this any reason why the Rubber Companies should be punished by the "practical confiscation" of their claims? Nor does the change in the directory justify such punishment, as this also was, as the master finds, without fraudulent intent.

How stands it as to the Metropolitan National Bank?

It was a stranger to the preferential arrangements in controversy until August 3, 1896, at which time Fargo & Co. was indebted to it $40,000 for borrowed money. At the same time two of the Fargos were indebted to a Michigan Bank upon a $10,000 note which had been previously given by them (with their individual bank stock as collateral security) to borrow that sum for C. H. Fargo & Co.

While in form this $10,000 was a debt of the Fargos as individuals, in equity and in reality it was a debt of the company to the Michigan bank, as will be shown later. If so, no one disputes that the company, although on the eve of failure, might have preferred the debt of $40,000 to the Metropolitan National Bank and the note for $10,000 of the Michigan bank. Yet this is in substance what was done when C. H. Fargo & Co. gave to the Metropolitan National Bank two preferential judgment notes aggregating the amount of its $40,000 note and the $10,000 Michigan bank note, and the $10,000 was furnished by the Metropolitan National Bank to Charles E. Fargo to pay the Michigan bank.

But if the Michigan bank note be regarded in law as a debt of the Fargo brothers, instead of their company, still the undisputed fact remains that they had borrowed this money for their company, and the company, at least, was indebted to them in that amount; so that at the worst the transaction amounts but to an unsuccessful attempt by the Fargos to obtain from their company, on the eve of its failure, a preferential payment of a debt honestly due by it to them. But the unsuccessful attempt even of a director to secure a preference from his company upon the eve of its failure does not work a forfeiture of his debt (*Brown* v. *Morristown Store Company*, *supra*).

But it is said by the Circuit Court of Appeals that, if no other valid reason exists for depriving the bank, not only of its preference but of its debt, one is to be found in what is termed the "entangling alliance" into which it entered with the Rubber Companies. What is here meant is that on August 6th and about the time the bank received its judgment note it entered into an agreement (Rec., p. 385) with the Rubber Companies, who also had judgment notes, "to unite their efforts to collect their respective claims against the said company and share *pro rata* in the results thereof." The only purpose of this, as the evidence shows, was to avoid conflicts respecting the priority of the respective executions, the Rubber Companies being about to enter their judgments in the Federal court, while the bank was obliged, and about, to resort to the State court.

However the conduct of the rubber companies before August 6th may be characterized, their conduct on and after that date—and it is in this only that the bank can be said to have participated—was but the assertion of a preference now said to be illegal. This, as already shown, is not sufficient to deprive even the rubber companies of the debts they sought to have preferred. How then can it deprive the bank of *its* debt?

It is difficult to appreciate how this pro-rating agreement can affect the rights of either the rubber companies or the bank. No penalty or punishment attaches to the legal assertion of claims. If either of petitioners is to be debarred from sharing with the other creditors in the general fund, it must be because its conduct has been intentionally injurious to creditors. How did this agreement, made on the day of failure, work a legal injury to such creditors? It did not, unless

the mere assertion as valid of preferences which were, *as a matter of law*, invalid, is a legal wrong. Under the foregoing cases it is not.

Hence a majority of the Circuit Court of Appeals erred in holding that petitioners were not entitled to share *pari passu* with the other creditors.

II.

There Is No Constructive Fraud.

The decision of the lower courts against the petitioners on this question cannot, it is believed, be reconciled with that of this court in *Sanford Tool Co.* v. *Howe*, 157 U. S., 312.

In the discussion of this question the following legal propositions are not questioned by the lower courts or respondents' counsel:

(1) These preferences, made in Illinois by a corporation of that state, are to be tested by the law of Illinois so far as declared.

Peters v. *Bain*, 133 U. S., 670.
Allen v. *Massey*, 17 Wall., 351.
Smith Purifier Co. v. *McGroarty*, 136 U. S., 237.

(2) The right of an individual debtor on the eve of failure to prefer one creditor to the exclusion of others exists in Illinois to its fullest extent.

Tomlinson v. *Matthews*, 98 Ill., 178.

elected at Beale's nomination should not hamper or interfere with the proper carrying on of the ordinary business of the company"; that "the only purpose and object of changing the board of directors as aforesaid, and amending the by-laws [by vesting in the directory the exclusive power to give judgment notes, etc.], was to protect the Rubber Companies against the giving by the Fargo Company of preferential security or judgment notes, which should be superior to the security of the Rubber Companies"; that "the arrangement as made was carried out in good faith by the parties, and that the directors elected, at the suggestion of Mr. Beale, took no part in the active management of the Fargo Company after their election; and, that no directors' meetings of Fargo & Co. were held after January 9, 1896, until August 5, 1896." These findings of the master are not controverted by the lower courts. Mr. Justice BROWN says (Rec., 736): "The device of changing the directors was only to secure the arrangement that no other judgment notes should be given." The evidence is undisputed that after the election of these directors, as well as before, the business of Fargo & Co. was managed and conducted by the three Fargos in the interest of the company and to the advantage of its creditors generally. (Rec., 162.)

Furthermore, no injury to the creditors from this change of directors is shown. It does not appear that the Fargos, during this period, wished or were willing to prefer any of the other creditors, except the Metropolitan National Bank. When, in August, they desired to prefer that bank the new directory by a resolution authorized it; and, as stated by the learned Circuit Judge (Rec., 636 B.), "none of the other creditors

attempted to obtain such [judgment] notes or any other preference before the general crash" and the arrangement "did not do any actual injury to the other creditors."

What then is here disclosed is simply an agreement made by a "going" corporation that the security (through which a new loan was obtained with which to continue business and overcome embarrassments) should not be impaired by, or made secondary to, preferential judgments to other creditors; a change of directors *solely for the purpose of assuring the performance of this agreement;* and the absence of any actual injury resulting therefrom to the company's other creditors.

The question thus presented is whether this change of directors for the purpose and to the extent above indicated is constructively fraudulent when made in good faith and without actual fraud.

The first question here is whether this change of directors was *per se* fraudulent regardless of the motive or purpose. In Illinois the right to elect directors is vested exclusively in the stockholders, whose motives the law does not concern itself with. They may act arbitrarily or from pure whim or fancy. They certainly may elect directors with a view to inspire in those with whom the company deals a confidence that its contracts will be fulfilled. They may—and frequently do—elect such directors as those dealing with the company nominate or suggest.

In *Kitchen* v. *R. R. Co.*, 69 Mo., 224 (page 242), an agreement that capitalists about to advance money to an embarrassed railroad company should have a "controlling voice in the directory in order that the money

"furnished might be thus [as agreed] applied and result "in giving them ample security for their investment," was held not constructively fraudulent.

Having this exclusive power of selection, the stockholders of a corporation can, in their discretion, select as its directors some of its creditors. There is no inconsistency in one's being at once a creditor and a director. The law permits a director to deal with his company and thereby become its creditor.

Harts v. *Brown*, 77 Ill., 226.

Why may not, then, a creditor become a director if the stockholders wish it? Even if these rubber corporations had been partnerships and five members of such firms had been elected directors, this would have infringed no right of creditors.

But the persons elected directors were not themselves creditors. They were clerks in the office of the counsel of the Rubber Companies, one being also assistant corporation counsel of the City of Chicago, and they were elected by a unanimous vote of the stockholders. It is not claimed that they were not, by character and capacity, qualified to be upright and intelligent directors; nor is there any evidence that they were, or were expected to be, improperly influenced in discharging their duties as directors by this relationship to the attorney of the Rubber Companies. At most it only gave the attorney a certain moral influence.

But such moral influence, even in the case of stockholders whose votes elect the directors, is neither illegal nor justifies the charge that the directors are "controlled" in any improper sense by those who elect them.

Porter v. *Pittsburg Bessemer Steel Co.*, 120 U. S., 649.

Pullman Palace Car Co. v. *Missouri Pacific*, 115 U. S., 587, 596.
Higgins v. *Lansing*, 154 Ill., 301, at page 357.

Nor will the law assume, in the absence of proof, that these directors—although elected upon the nomination of Mr. Beale—were to, or would, as directors, act illegally or fraudulently.

Allen v. *Wilson*, 28 F. R., 677.
Rogers v. *Nashville Ry. Co.*, 91 F. R., 299, at page 313

Clearly, then, the creditors of Fargo & Co. could not, in January, 1896, have induced any court to interfere with, and cannot now complain of, the mere selection, by its stockholders, of Mr. Beale's nominees as directors. It being lawful for stockholders to select them, it was not unlawful to *agree* to do so. Hence neither the agreement to elect nor the election of these directors constituted in *itself* a legal fraud.

Not that the selection of directors may not be a part of a fraudulent transaction. In such case, however, it must be a means to a fraudulent end. There the fraud arises—not from the fact of such selection—but from its purpose or object. As the "only purpose and object" of this change of directors was to carry out the company's agreement not to give their other creditors a superior preference, the real question is whether such an *agreement* is a fraud on its other creditors. If so, a preferential transaction containing such agreement would be illegal, although it did not provide for a change of directors. If it was not illegal, the change of directors would not make it so.

While all the learned judges in the lower courts seem to have regarded the change of directors as an element of fraud, the opinion of but one (Judge Grosscup) states the reasons therefor. In his opinion on the final hearing (Rec., p. 636 a) he says:

"The vice in the conduct of the Rubber Companies and the Candee Company consists in their attempting to tie up the corporation against the power to give like preferences in favor of others."

(See also his opinion on interlocutory hearing. Rec., p. 84.)

The supposed vice, then, when this transaction is fundamentally considered, must be, not the change of directors, but the agreement or purpose of the parties to restrict Fargo & Co.'s power to prefer other creditors. The question then is not confined, as the learned judges seem to think, to corporations, but concerns individuals as well. A corporation's right to prefer creditors (other than directors) is similar to that of an individual. Hence the creditors of an individual are as much wronged as are the creditors of a corporation by an agreement or other pre-arranged purpose to "tie up" their debtor's power to prefer them.

Hence the real question is whether an agreement or other arrangement by a debtor, either individual or corporation, that a preferential judgment note (in part securing a present loan) should not be impaired by subsequent preferences to others, is a fraud or wrong upon creditors. If so, it must be—since every wrong implies the existence of a right—because it infringes some *right* of the creditors.

What right of creditors, then, is here infringed? This involves the consideration of what, and whose, is this

right to prefer. Property includes the right to dispose of (as well as use) the thing possessed. This right to transfer includes the right of the debtor to assign his property to his creditor in payment of or as security for, his debt. This latter right—commonly known as the right to prefer—continues so long as the owner retains dominion over his property. It is subject to but two limitations—the right of the state to provide by bankrupt or insolvent laws for the ratable distribution of an insolvent's estate, and a limitation prohibiting conveyances by him with the intent to hinder, delay or defraud creditors. Subject to these two limitations—well established long prior to the adoption of the Federal or any state constitution—this right to prefer is as completely within the constitutional guarantee of the right of property as any other property right.

This right to prefer, being based upon the *jus disponendi* which the owner of property retains so long as his ownership continues, precludes the idea that a debtor's creditors have any legal interest in its exercise. The right is personal to the debtor. It is exclusively his. He may exercise it or not, as his caprice or fancy suggests. His motives cannot be inquired into. He may exercise it as to all, or a part of the property, at any time he sees fit, and in favor of any one, even the least meritorious of his creditors. If the debt be *bona fide* he may exercise it when, as, and so far as, he pleases. His exercise of it, or his failure to exercise it, or his exercise of it in a particular way, infringes no right of his creditors.

Is it not then illogical to say that a debtor, who may prefer or not, as he pleases, may not, especially to obtain a loan, voluntarily submit to a self-imposed restriction

upon his future power to prefer; or may not stipulate for the order of priority of his preferences—which is all Fargo & Co. did in this case?

He may by non-action, or by making an actual transfer of all his property to one creditor, or by giving one judgment note of sufficient size to absorb his entire assets and afterwards refrain from giving other notes, prefer exclusively one creditor. So by the actual exercise of his power to prefer (in point of time or otherwise) he may in fact lawfully create such order of priority in his preferences as he sees fit. If so, how is it unlawful for him to *agree* to do so?

If it infringes the right of creditors "to tie up" the debtor's right to prefer, then an agreement by a debtor with a creditor to give no preferences *at all* in case of subsequent failure would be equally illegal. All this is repugnant to the very nature of the right to prefer. It belongs to the debtor. The creditors have no legal interest in it whatever.

Again, the position of the lower courts on this point is based upon the right of creditors to have this power to prefer kept free and untrammeled. If such right exists it involves—in the case of a corporation—a correlative duty of its directors. If the law is to protect creditors in this right, it must, especially in equity, which looks at substance rather than form, condemn everything—whether agreement or other arrangement—that destroys it. Self interest is the strongest motive of human conduct. In the case of directors it is at least as potent as the sense of obligation arising from the contracts of their company. If its creditors have this right, they must be allowed to insist that directors—from whom their preferences must emanate—should not, in dealing with

their corporation, place themselves in a position where their self-interest will conflict with this duty to creditors.

Such is human nature that no corporation will often give a preference to others that impairs previous preferences to a majority of its directors. Here is a situation arising from self interest that is as potent "to tie the hands of the corporation against the power to give like preferences in favor or others" as would be an agreement of the corporation. If one is fraudulent because depriving creditors of a right, equity must also condemn the other.

Hence, this new theory, if it be engrafted upon the law, must be carried to a logical conclusion, by annulling all undisclosed preferences to directors, especially to a majority of the directors.

But this is directly inconsistent with the decision of this court in *Sanford Tool Co.* v. *Howe*, 157 U. S., 312, and of the Illinois Supreme Court in *Illinois Steel Co.* v. *O'Donnell*, 156 Ill., 624.

In the former case an insolvent corporation gave to a *majority* of its directors a mortgage upon its manufacturing plant, which, although kept off the records for two months, was upheld. Here, then, was the creation of a situation which was as effectual, as any agreement of the corporation would have been, to prevent the company from giving other preferences upon this plant.

In the *O'Donnell* case a judgment note given by an insolvent corporation to *three of its five* directors, of sufficient size to absorb its assets to the exclusion of its general creditors, was upheld, although undisclosed for eight months, during which time the corporation conducted its business and obtained credit.

(3) An Illinois corporation, although insolvent and contemplating ceasing business, has the same right as an individual to prefer creditors other than directors.

Reichwald v. *Commercial Hotel Co.*, 106 Ill., 451.

Gottlieb v. *Miller*, 154 Ill., 44.

Glover v. *Lee*, 140 Ill., 102.

Warren v. *First National Bank*, 149 Ill., 9.

(4) An Illinois corporation if contemplating the continuance of its business may, although insolvent, give judgment notes to its directors for a present loan of money.

Illinois Steel Co. v. *O'Donnell*, 156 Ill., 624.

Whether such corporation could give a preference in part covering a pre-existing debt and in part for money advanced to aid the company to continue its business has not yet been distinctly decided by the Illinois court. In the absence, however, of such decision that of this court in *Sanford Tool Co.* v. *Howe*, 157 U. S., 312, upholding such preference *in toto*, would control.

(5) Debts for which the directors are liable as endorsers, etc., may be preferred by an Illinois corporation on the eve of its failure.

Blair v. *Illinois Steel Co.*, 159 Ill., 350.

Rockford Co. v. *Standard Co.*, 175 Ill., 89.

(6) Directors may be even relatives of the preferred creditors without invalidating the preference.

Ragland v. *McFall*, 137 Ill., 81.

Illinois Steel Co. v. *O'Donnell*, 156 Ill., 624.

(7) The giving of judgment notes is recognized in Illinois as a legitimate method of preference.

Field v. *Ridgely*, 116 Ill., 424.

Hegeler v. *First National Bank of Peru*, 129 Ill., 157.

In the light of these undisputed legal principles, it is proposed now to examine separately the preferences to the Rubber Companies and the Metropolitan National Bank.

First as to the Rubber Companies. It is to be noted at the outset that the rule prohibiting the directors from preferring themselves when contemplating a cessation of business has no application. The preferences of the Rubber Companies are not of this character. In granting such preferences Fargo & Co. and the Rubber Companies dealt at arm's length. None of its directors or officers were then either directly or indirectly connected with the Rubber Companies. Their preferences were not a result of the election of the directors nominated by Mr. Beale. On the contrary, the election of such *new* directors was the result of the contract for preferences previously made by Fargo & Co. through its old directors. The new directors by no vote or act contributed to, or participated in, the giving of these preferences. Besides they were given when Fargo & Co. was a going concern and not contemplating failure.

This is equally true of the assignment of the accounts. While the actual assignment thereof was not made until August 6, it was then made by the president, Charles E. Fargo, acting in obedience to a resolution passed by the old directors on January 6. The new directors did not participate in it. This conditional promise to assign

was valid (*Smith* v. *Craft*, 17 Fed., 705; *Feekheimer* v. *Baum*, 43 Fed., 719; *Natl. Bank* v. *Whitmore*, 104 N. Y., 297), and its performance in August would relate back to the promise in January.

National Bank v. *Whitmore*, 104 N. Y., 297.

Clerk v. *Iselin*, 21 Wall., 360.

Haslet v. *Harrison*, 105 U. S., 401.

South Branch Co. v *Ott*, 142 U. S., 622.

Douglass v *Vogeler*, 6 Fed. Rep., 53.

In view of the foregoing cases it seems to be conceded by the lower courts that the preferences to the Rubber Companies, without the element of secrecy and the provision for change of directors would be valid. They held, however, that the element of secrecy, either by itself or accompanying the change of directors made constructively fraudulent such preferences.

Judge Grosscup, in his first opinion (Rec., 86), concedes "that the judgment notes themselves would not have been a fraud in law; the assignment of the accounts or the plant at Dixon would not have been of themselves a fraud in law," but that accompanied by the change of directors they were constructively fraudulent. The opinion of Judge Woods lays stress upon the intentional maintenance of secrecy as fraudulent.

SECRECY AS AN ELEMENT OF FRAUD IN PREFERENCES.

On this point the master found as follows:

"The matter was kept secret in order to allow Fargo & Co. an opportunity of getting through embarrassments apparently temporary, but not with a fraudulent intent as to the other creditors of the company."

This finding is amply sustained by the evidence, and we do not understand that its correctness is questioned by

the majority opinion of the Circuit Court of Appeals. The only conceivable *fraudulent* intent or motive in keeping the matter secret would be to thereby purchase goods on credit to subsequently levy upon, but this opinion says:

"It was not, as alleged in the bill, a part of the plan that increased purchases should be made for the pupose of improving the security of the Rubber Companies."

It is not claimed that there was any agreement for secrecy, but Judge Woods says:

"The master's finding on the point implies, and the evidence demonstrates, a *mutual understanding* between those concerned that secrecy was necessary, and an express agreement that it should be kept would not have made the understanding more clear or its fulfillment more imperative. * * * Secrecy kept for a purpose is not accidental or unintended; it is premeditated; it is in essence the same as if agreed upon."

Thus the learned judge seems to assert that in Illinois *intentional* secrecy in itself renders a preference fraudulent; that secrecy kept for apurpose—however commendable that purpose—avoids a preference; that intentional secrecy, although solely for the purpose of enabling a corporation to get "through embarrassments apparently temporary," is wrongful.

Whatever be the decision in other states—and in them there is some conflict and confusion—it is certainly beyond question that in Illinois intentional secrecy in a preference, although followed by the giving of credit which, without it would have been withheld, is not a fraud on the creditors unless the *motive* is fraudulent. A preferential agreement kept secret with a legitimate motive, or for a legitimate purpose, is not fraudulent because it *results* in the giving of credit that would otherwise have been withheld. The policy of the law in Illinois is firmly

settled. It recognizes the right (as does this court in *Sanford Tool Company* v. *Howe*, *supra*) of an embarrassed debtor, whether individual or corporation, to struggle to outlive financial embarrassment. It appreciates that this struggle requires the continuance of purchases on credit. It recognizes the right of such a debtor to give judgment notes, and does not require such judgment notes (as it does mortgages) to be recorded, nor provide by statute for any public notice thereof. It exacts of an embarrassed company no unsought disclosure of its outstanding judgment notes. It imposes upon the creditor the duty of inquiry from his debtor. It condemns the keeping secret of judgment notes, where the purpose is to increase the assets to levy upon, for here the *intention* is wrongful. But it upholds judgment notes intentionally kept secret, although followed by purchases on credit, where the purpose is honest—the continuance of the business in the expectation of outliving embarrassments. The test in Illinois is not whether the secrecy is intentional or not, but whether the purpose of the secrecy is honest or dishonest. To hold otherwise would be to practically inhibit the giving of judgment notes—a favorite form of security in Illinois. If, as seems to be the case, the position of the majority of the Circuit Court of Appeals is that secrecy kept for the purpose of enabling Fargo & Co. to outlive embarrassments is fraudulent, because it permitted a credit which was undeserved, it is opposed to the Illinois law, which is sufficiently disclosed by the two following cases:

In *Hegeler* v. *First National Bank of Peru*, 129 Ill., 157, the facts and contentions of the attacking creditors, except in the feature of the change of directors, were strikingly like those in the case at bar. A corporation be-

came insolvent and offered to secure a debt to its bank by mortgage, but this "the bank refused, *because it would injure the credit of the glass company and prevent it from obtaining elsewhere further credit*," and in lieu thereof the bank took from the corporation judgment notes for its indebtedness. *Here was a clear case of intentional secrecy to avoid injury to credit.* These notes were retained without the entry of judgment thereon *for more than a year.* The corporation during this time continued its business, and the attacking creditors advanced the corporation money upon false statements by it of its financial condition, and, it was claimed, "upon the delusive and fictitious credit given it by said First National Bank of Peru [the preferred creditor], in allowing it to retain all its property apparently free from incumbrance," and that, had the attacking creditors "known or suspected the existence of such judgment notes, they would have given no credit or loan whatever to such glass company"; and that "such concealment enabled the debtor to deceive and mislead other persons to give it credit that would otherwise have been withheld." But the court upheld the preferential judgment, saying, at page 163:

"The argument proceeds throughout upon the proposition that the bank took its notes and held them under circumstances that made its conduct operate as a fraud upon others. There is no pretense that there was any agreement to conceal its claim against the glass company, much less that any such agreement was made for the purpose of enabling the company to obtain credit from others. No evidence can be found in the record proving, or tending to prove, acts or declarations on the part of appellee calculated to induce appellant to give credit to the glass company. There is nothing in the bill, and certainly nothing in the evidence, to show that at the time appellee took its notes, and refused to take mortgage security, it did not honestly believe that, notwithstand-

ing the insolvency of the glass company, it would, if its credit could be maintained, successfully recover from its embarrassment, continue business, and pay all its debts."

In *Field* v. *Ridgley*, 116 Ills., 424, a firm, being largely in arrears to a creditor, executed to him judgment notes and thereafter continued as before to conduct an extensive mercantile business on credit *for four years*, when it failed. Judgments entered on these judgment notes were attacked as a fraud on creditors in that they had been induced to sell goods to the firm when "insolvent," a fact known to the judgment creditor, but not to the attacking creditors; but the court upheld the preference, saying, at page 431:

"The acts of fraud relied on * * * are no evidence of fraud at all. * * *

"As to the complaint that appellees held the notes so long without giving notice of their having them, we perceive no force in it. There is no law or mercantile usage, so far as we are advised, that requires one in business to disclose the state of his accounts with his customers to others having dealings with them, and there are manifest reasons why this should not be done except when the creditor is specially interrogated on the subject by one having a personal interest in knowing. It is not charged in this case that appellants ever sought any information of appellees [judgment creditors] in respect to the claims of the latter against Kimber, Ragsdale & Co., or that they ever said or did anything, outside of what we have already stated, to mislead appellants with respect to Kimber, Ragsdale & Co.'s indebtedness to appellees, or in respect to the manner in which such indebtedness was secured. The forbearance of a creditor to crush out a struggling debtor upon the first opportunity, with a view of enabling him to overcome business misfortunes, ought not to be converted by judicial construction into a species of fraud. On the contrary, so long as the creditor's conduct is characterized by good faith, as was evidently the case here, such forbearance should be regarded by the courts with favor, rather than otherwise."

It is here worthy of note that Judge Grosscup, himself an Illinois lawyer of large experience at the bar, concedes that the giving of judgment notes to the Rubber Companies, although accompanied by intentional secrecy and followed by the giving of credit which, with a knowledge of the facts, would have been withheld, would not be fraudulent under the Illinois law, if it had not been accompanied by a change of directors.

What is here said of secrecy concerning judgment notes is equally true of the secrecy respecting the change of directors. The law of Illinois does not require public notice of the election or change of directors. Creditors are left to ascertain by inquiry, if to their interest to do so, the personnel of the directory. Here, too, while the law does not permit false answers to inquiries, it does not require unsought disclosures. In either case it is the intention or purpose which determines whether secrecy makes the preferential transaction fraudulent or not.

As secrecy here was concededly for a legitimate purpose, the decision of the Circuit Court of Appeals in so far as it avoids on this grounds these preferences was repugnant to the Illinois law.

Did the change of directors make the preferences to the Rubber Companies constructively fraudulent?

The facts concerning this are as follows:

The Fargo Company, in the January arrangement resulting in the loan of $50,000, agreed "that it should not give any judgment notes to other creditors which would impair the security of the Rubber Companies"; that five of the then directors should resign and the stockholders should elect five new directors, to be nominated by Mr. Beale, and "that the directors so to be

That case, in principle, should control the case at bar. The agreement here, supplemented by the election of directors from the office of the Rubber Companies' counsel, did not create one iota more of "inability" by the corporation to subsequently "give like preferences" than existed in the *O'Donnell* case. This inability in either case arose from the constituency of the board of directors, supplemented in the one case by an agreement, and in the other by self-interest. Had the Rubber Companies been firms, and had five of their members been elected directors instead of the clerks from their counsel's office, this agreement would have added nothing to the situation. Their self-interest would have been sufficient. In that event this case would have differed from the *O'Donnell* case only in that the interested directors in the latter case were elected before the preferences were given, and in the present case afterwards. The supposed unlawful result, however, would be the same. So, too, the case at bar is, in principle, like the *O'Donnell* case, despite the fact that in the former the condemned result proceeds in part from an agreement, and in the latter only from the self-interest of directors.

This position of the lower court is equally at variance with the principle of all the cases which sustain an undisclosed preference to a single director. For if creditors of a corporation are entitled to the unbaised and free exercise of the right to prefer, this is impaired (although in lesser degree) when *one* director is preferred. For that one director will not vote for any preference which will impair his preference.

It is therefore respectfully urged that the change of directors did not make these preferences fraudulent.

It is said in the majority opinion of the Court of Ap-

peals to be a fraud upon the law to constitute the directors and treasurer "pledged not to give attention to their duties, or to participate in the management of the business of the corporation."

As applied to the *directors* there is nothing in this record to sustain the charge that they were pledged not to give attention to their duties. All that it shows is an agreement (see master's report) that the directors "should not hamper or interfere with the proper carrying on of the ordinary business of the company." Nor is there evidence that these directors did in fact fail to give attention to their duties. All that the evidence discloses is that they "took no part in the *active management* of the company after their election." (Master's report.) This constituted no omission to discharge their duties.

The Illinois Incorporation Act (Ill. Revised Statutes, Chapter 32, Section 6) provides that "the *corporate powers* shall be exercised by a board of directors or managers." Thus the duties of the directors involve only the exercise of corporate powers, and no court in Illinois has ever held or even suggested that participation in the active management of the ordinary business of a trading corporation is a corporate power, or that a director who does not do it fails in his duty to his company. According to the universal course of corporate business in Illinois, directors fully meet the requirements of their office when they select the officers and agents to conduct the company's business.

As applied to the *treasurer*, the legal proposition above stated does not arise in this case, because the fact upon which it is based is not presented by this record. The bill nowhere charges as an element of the fraud that the

treasurer of this company was pledged to neglect his duties or failed to participate in the management of the company's business. The master, in finding the facts and what the agreement of the parties was, omits to find any such pledge or agreement or any such conduct by the treasurer. This omission in the master's report was not made a basis of any exception. The master's report, except as to the points excepted to, became final by the confirmation of the Circuit Court. Hence this alleged fact was not before the Court of Appeals. Any reference to the evidence, therefore, is inappropriate here, and the Court of Appeals erred in making—if it intended to—any such alleged pledge or agreement or conduct a ground of its decision.

As to the Metropolitan National Bank. Was its preference constructively fraudulent? The bank did not appear upon the scene until about the 3rd of August, at which time Fargo & Co. was indebted to it on promissory notes for $40,000 for money borrowed in the regular course of business. It was never in any way connected with or represented on the directory of Fargo & Co. Hence, under the Illinois law, it had the undoubted right to accept from that company, upon the eve of its failure, a preferential judgment note for the amount of its claim.

Upon the representation of one of the Fargos that a Michigan bank held a note of himself and his brother for $10,000, borrowed for the Fargo Co., and that he desired $10,000 from the bank to pay that note and release his individual collateral (the truth of which is not disputed in the evidence), the bank loaned him $10,000 and took two judgment notes of the Fargo Company for $25,000 each, representing its existing claim for $40,000 and the new loan of $10,000.

One of these notes the parties undertook to pay by the transfer of Fargo & Co.'s factory at Dixon, and the other is the one upon which the judgment above referred to was entered in favor of this bank.

If the bank's preference is constructively fraudulent, it must be because it is made so by this $10,000 transaction. It is not thus made so unless this $10,000 was either (1) a misappropriation of corporate funds or (2) an illegal preference of a corporate debt. As there is no evidence to disprove the statement of C. H. Fargo that the $10,000 borrowed from the Michigan bank was used in the business of the Fargo Company, there is no warrant for saying that the receipt by Mr. Fargo of this money was a fraudulent withdrawal of corporate funds. The Fargo Company by this transaction was at least a debtor to the Fargo brothers in the sum of $10,000, and at most the receipt of this money by Mr. Fargo was but a preferential payment by Fargo & Co. to two of its directors on the eve of its failure.

But if in legal contemplation the note of the Michigan bank, while in form that of the individuals, was in reality and in equity that of the Fargo Company, then its payment, although on the eve of failure, was allowed by the Illinois law, and cannot be condemned as an illegal preference, although two of the directors, by reason of the pledge of their individual stock as collateral thereto, occupied with reference to that note a position akin to that of indorsers. (See cases above cited).

The Fargo Company, having thus the right to prefer its debt to the Michigan bank, might legally prefer a note given to the Metropolitan Bank to raise money to pay the Michigan bank. This is but a substitution of

one debtor for another, either of which could be legally preferred upon the eve of its failure.

Was then this note made by the Fargo brothers to the Michigan bank in legal contemplation the debt of the Fargo Company? We claim it is upon principle and upon the authority of

Poole v. *West Point Association*, 30 Fed. Rep., 513,

the facts of which are as follows:

The West Point Butter and Cheese Association was a corporation organized under the laws of the State of Nebraska, and one D. B. Brown was its president. The Middleton bank had advanced moneys directly to the corporation, and also advanced moneys to Brown, who had expended the same for the benefit of the corporation. These last advances the stockholders of the corporation had attempted to secure by pledging their shares of stock with the bank In an action by certain creditors of the West Point Butter and Cheese Association to dissolve the corporation, the receiver of said Middleton Bank was a cross-complainant, and as such sought to recover and charge said corporation with the moneys advanced by said bank to the corporation, and to Brown for its benefit, as debts of the corporation. It was held that equity would treat both sums as debts due by the corporation to the bank.

The court, Mr. Justice BREWER (page 518), said:

"I notice, second, the claim of the cross-complainant, the receiver of the Middleton Bank. His claim arises for moneys advanced by the bank directly to the association, and also for moneys advanced by it to Brown, which were by him expended for the benefit of the association, and which were recognized by the association informally as debts of the association, and which were attempted to

be secured by an assignment to the bank by each stockholder, personally, of his shares. *I think equity will jump all intermediate transactions, and treat both amounts as debts from the association to the cross-complainant.*"

It is therefore submitted that the Metropolitan National Bank's preference was not fraudulent.

For the reasons above stated the petitioners respectfully ask the issuance of a writ of *certiorari*.

EDWARD S. ISHAM,
GEO. A. FOLLANSBEE,
HENRY S. ROBBINS,
Counsel for Petitioners.